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Article

"Machinery investment is likely to experience the strongest declines as a result of the uncertainty": Seven questions to Malte Rieth

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Dr. Malte Rieth, Research Associate
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SEVEN QUESTIONS TO MALTE RIETH

»Machinery investment is likely to experience the strongest declines as a result of the uncertainty«

1. Dr. Rieth, you've investigated the possible consequences of the recent spike in uncertainty related to the Brexit vote. How exactly did you measure the change in economic uncertainty here? We isolated one specific aspect that was undoubtedly related to the "Leave" vote: the change in economic uncertainty that took place overnight between June 23 and June 24, 2016. We tried to accurately quantify this isolated aspect through a counterfactual analysis, keeping constant all other factors affecting the economies of Germany and the euro area. We did not take into account other major events that resulted from the decision, such as the resignation of the prime minister or the reactions from European partners. Additionally, our analysis should not be considered a forecast.
2. How will the uncertainty affect the German and European economies? The uncertainty has negative consequences for both Germany and the euro area on the whole. Over the next eight months, euro area GDP will decrease by roughly a quarter of a percentage point; for Germany, the impact is slightly larger but of similar magnitude.
3. Which of Germany's economic sectors will be most affected? Investment, above all. Investment suffers the most under uncertainty, and in this instance, machinery investment will experience the strongest declines.
4. What are the effects on the labor market, asset prices, and consumer prices? Again, the uncertainty is likely to have a negative impact. It should lead to an increase in unemployment – not dramatically, but noticeably. Consumer prices are likely to drop due to the decline in economic activity, which is especially bad in the current environment, since the euro area is already suffering from low inflation. The uncertainty is also expected to lead to an initial drop in equity prices.
5. How long are the effects of the uncertainty expected to last? According to the estimated macroeconomic model, which is based on historical relationships between uncertainty and macroeconomic variables, we will reach the trough in approximately eight to ten months. After this, things will gradually start to improve again. But even two years into the future, the GDP is still likely to be below the level it would have been in a no-shock scenario.
6. Would a faster withdrawal of Britain from the EU reduce the uncertainty? Yes, this would probably reduce uncertainty overall, but it of course depends on the configuration of the exit. Uncertainty is only one factor – if it's only about reducing uncertainty, action could be taken more quickly, but there are other aspects that must be considered. For example, negotiating mutually beneficial contracts may be far more important than simply reducing uncertainty.
7. What can be done to mitigate the adverse effects of the uncertainty shock? Our results show that investment above all will be negatively affected, so it would be particularly helpful to focus on strengthening it both in the euro area as well as Germany. This could be accomplished through greater government involvement, such as initiatives that promote private investment.

Interview by Erich Wittenberg



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